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No. 40

IN THE

Supreme Court of the United States

OCTOBER TERM 1929

FAWCUS MACHINE COMPANY, a Corporation,
Petitioner,

v.

THE UNITED STATES OF AMERICA

BRIEF IN SUPPORT OF PETITION FOR CERTIORARI

J. S. Y. IVINS,
Attorney for Petitioner.
c/o HOLMES, BREWSTER & IVINS,
815 Fifteenth Street, N. W.,
Washington, D. C.

Rufus H. Darby Printing Co. Inc., Washington, D. C.

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No. 625

IN THE

Supreme Court of the United States

OCTOBER TERM 1929

FAWCUS MACHINE COMPANY, a Corporation,
Petitioner,

v.

THE UNITED STATES OF AMERICA

BRIEF IN SUPPORT OF PETITION FOR CERTIORARI

OPINION BELOW

The Court of Claims rendered no opinion except the following memorandum:

"This case falls within the decision of the Supreme Court in the case of *United States* v. *Yale & Towne Mfg. Co.*, 269 U. S. 422, and the following citations, viz: *Nichols* v. *Sylvester Co.*, 16 Fed. (2d) 98; *Bowers* v. *Kaufmann & Co.*, 18 Fed. (2d) 69; *Russel Wheel and Foundry Company*, 3 B. T. A. 1168. The petition is dismissed. It is so ordered." (R. 28).

It has not yet been officially reported in the Court of Claims Reports.

JURISDICTION

The judgment of the Court of Claims was entered on November 4, 1929 (R. 28). The jurisdiction of this Court is invoked under Section 288 of the United States Code (Act of February 13, 1925, ch. 229, § 3).

STATEMENT

This case was instituted by the petitioner in the Court of Claims to recover excess profits taxes for the year 1919 alleged to have been overpaid. The Court of Claims, after finding the facts in accordance with a stipulation by the parties, dismissed the petition with the memorandum quoted above.

The petitioner in March, 1920, filed its income and profits tax return for the calendar year 1919 (R. 25 ¶ II) and subsequently filed amended returns. The total amount originally paid (in various installments) was $43,119.26 (R. 25 ¶ II). The Commissioner of Internal Revenue determined the petitioner's liability for taxes for 1919 to be $41,182.77. The difference was refunded (R. 25 ¶ III). The petitioner claims that the further sum of $1,597.85 should have been refunded on the ground that the Commissioner erroneously reduced petitioner's invested capital for 1919 below the correct amount allowable under the statute.

Under the provisions of the Revenue Act of 1918, more particularly Section 326 thereof, the invested capital of a corporation includes cash and property (subject to certain limitations) paid in for stock, and paid-in or earned surplus and undivided profits, not including surplus and undivided profits earned during the year. The total taxes due from plaintiff for the year 1918 amounted to $78,784.95, which were paid in four equal installments on or about the 15th days of March, June, September, and December, 1919. Under the regulations then in force in respect of such taxable year applicable to the relationship between invested capital of one year and taxes of the preceding year the amount of such taxes was included by the Commissioner of Internal Revenue

in the invested capital of the plaintiff for the year 1919 only until the installments were actually paid, the balance being excluded. This was accomplished by determining the average deduction for the year and reducing the earned surplus on January 1, 1919, by that amount. The amount of the average deduction was $33,294.68.

During the taxable year 1919, at the time each installment of 1918 income and profits taxes of the plaintiff became due and payable, the plaintiff had on hand surplus or undivided profits, earned during the taxable year 1919. more than sufficient to pay such installment (R. 26 ¶ V).

Petitioner claims that its earned surplus for 1919 should not have been thus reduced and that the difference in taxes attributable to such erroneous reduction should be refunded.

SPECIFICATION OF ERRORS TO BE URGED

The Court of Claims erred in holding that the plaintiff was not entitled to recover and that the petition should be dismissed. The decision of the Court of Claims amounted to a ruling that the Commissioner of Internal Revenue acted correctly in reducing the petitioner's 1919 invested capital by the amount of its 1918 income taxes prorated from dates of payment.

The decision of the court necessarily involves either (1) a ruling that petitioner was required by the Revenue Act of 1918 to accrue a tax as of a date prior to the passage of the statute imposing the tax although at that time it would obviously have been impossible to determine the amount to be accrued, or (2) a ruling to the effect that in the Revenue Act of 1926 Congress, without amending the Revenue Act of 1918, could take upon

itself the judicial function of interpreting the Revenue Act of 1918.

SUMMARY OF THE ARGUMENT

I. Invested Capital is Not Affected by Current Earnings or Expenses.

Article 845 of Regulations 45 was based upon two fallacies, to wit: (1) that income taxes are payable out of the net income of the taxable year for which they are levied; and (2) that it was possible to determine 1918 income taxes at the end of 1918 (the Revenue Act of 1918 not being passed until February, 1919).

II. Income and Profits Taxes are Current Expenses When Due and Payable.

They are properly payable out of current earnings for the year in which they become due and payable.

III. The Opinion of This Court in United States v. Anderson (260 U. S. 422) is not Applicable to Invested Capital for the Year 1919.

The court was there concerned with income, not with invested capital. It based its decision on the fact that all the events necessary to fix the tax had occurred before the end of the taxable year. In this case, the primary event—the passage of the statute imposing the tax —did not occur until after the close of the taxable year.

IV. A Tax Cannot Be Determined Before the Passage of the Statute Enacting it.

Consequently, a tax cannot be accrued on the books of the taxpayer until the enactment of the statute imposing the tax, as has been held in various cases at the instance of the Government.

V. The Congressional Intent in the 1918 Act.

Congressional Committee Reports show clearly that Congress expected the 1918 taxes to be paid out of 1919 income.

VI. Section 1207 of the Revenue Act of 1926 is Not Applicable to the Facts of This Case.

The purpose of Section 1207 was to relieve the Treasury Department from the burden of attempting to collect additional excess profits taxes based on a hasty construction of *United States* v. *Anderson*, 269 U. S. 422, and was not intended to determine the question whether taxes as already collected were in part erroneous.

VII. The Treasury Department's Construction of Section 1207 of the 1926 Act Raises Serious Doubts as to its Constitutionality. Such a Construction is Avoidable.

To declare what the law has been is a judicial function. The Revenue Act of 1926 did not purport to amend the Revenue Act of 1918. To treat it as a construction would render it a usurpation of the power of the courts.

Section 1207 of the Revenue Act of 1926 on its face shows an intent to relieve the Treasury from the duty of going after additional taxes without interfering with the right of the courts to hold that some of the taxes as previously collected were erroneous.

VIII. The Authorities Cited Below Distinguished.

The court cases cited do not involve facts similar to those in the instant case, nor therefore the same issue. The Board decision mentioned includes no reasoning and is therefore of little weight.

ARGUMENT

I. Invested Capital is Not Affected by Current Earnings or Expenses.

The Treasury Department promulgated Article 845 of Regulations 45* on the theory that income and profits taxes for a given year, although not due and payable until certain dates in the following year, were determinable at the close of the given year, and should be deemed to have been paid out of the income of that

*Article 845 reads:

"*Surplus and Undivided Profits; Reserve for Income and Excess Profits Taxes.*—For the purpose of computing invested capital federal income and war profits and excess profits taxes are deemed to have been paid out of the net income of the taxable year for which they are levied. It is immaterial, therefore, whether reserves for the payment of such taxes for the preceding year have been set up or not, or if set up whether such taxes when paid have actually been charged against such reserves. Amounts payable on account of such taxes for the preceding year may be included in the computation of invested capital only until such taxes become due and payable. A deduction from the invested capital as of the beginning of the taxable year must therefore be made for such taxes or any installment thereof, averaged for the proportionate part of the taxable year after the date when the tax or the installment is due and payable. Where as a result of an audit by the Commissioner, or the acceptance of an amended return, or for any other reason, the amount of any such tax for the preceding year is subsequently changed, a corresponding adjustment will be made in the invested capital for the taxable year upon the same basis as if the corrected amount of the tax for the preceding year had been used in the original computation of the invested capital for the taxable year. See articles 1541 and 1542."

year. However, because they were not due and payable within the year, but so much of the income of the taxable year remained among the assets of the taxpayer until dates for payment in the next year, the regulation permitted "amounts payable on account of such taxes" to be included in invested capital in the next year, but "only until such taxes become due and payable."

This regulation was based upon two fallacies: (1) there is no basis for regarding income taxes as payable out of the net income of the taxable year for which they are levied; and (2) in the case of taxes for the calendar year 1918, at least, they were not determinable at the end of that year.

A corporation commenced a taxable year with invested capital consisting of (a) cash and property (subject to limitations contained in Section 326 of the Revenue Act of 1918) paid in for stock, and (b) paid-in or earned surplus and undivided profits; not including surplus and undivided profits earned during the year. This invested capital might be increased during the year by the payment in of additional capital in exchange for new stock, or by way of paid-in surplus, but not by current profits —they would only affect surplus as at the end of the year and go into the invested capital of the following year. By the same token, the invested capital would be reduced only by *capital paid out* during the year (e. g. liquidating dividends or dividends paid out of previously earned surplus, but not dividends paid out of cur-

rent earnings). Current expenses of any kind, would not reduce the invested capital for the year, for until the end of the year it would be impossible to tell whether such expenses exceeded receipts, and they would presumably be paid out of the current receipts for the year. If they did prove to exceed receipts, the difference would be a loss for the year—the converse of current profits—which would reduce surplus only as at the end of the year, and like surplus earned during the year, be reflected in the *next* year's invested capital.

So the average invested capital for a year would be the initial invested capital plus additional capital paid in by stockholders (not earnings) for the fraction of the year subsequent to its payment-in, and minus *capital* (including surplus carried over from the previous year) paid out to stockholders, for the fraction of the year subsequent to its payment-out. Payments to stockholders out of current earning did not reduce average invested capital, any more than the receipt and retention of current earnings increased it. And payments to others than stockholders did not reduce average invested capital for the year any more than receipts from others than stockholders, for only at the end of the year could it be determined whether the disbursements exceeded the receipts—whether there was profit or loss—whether earned surplus should be increased or reduced. *And the statute certainly did not contemplate the reduction of average invested capital for the year by current losses, when it specifically prohibited its increase by current earnings.*

Distributions to stockholders by way of dividends(except liquidating dividends), are presumed paid out of current earnings.*

If payments to stockholders out of current earnings do not reduce average invested capital for the current year, a fortiori payments to others out of current earnings do not reduce average invested capital. Business expenses are presumed paid out of earnings, not capital. And taxes, including income taxes, are business expenses. They were even deductible in computing taxable net income under the Corporation Excise Tax Act of 1909 and the Revenue Acts of 1913 and 1916. In the subsequent Revenue Acts** the deduction of Federal income and profits taxes was specifically prohibited in the computation of *taxable* net income, but the statutes made no provision that their payment should affect *invested capital.*

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* Rev. Act of 1918 § 201 (b). "Any distribution shall be deemed to have been made from earnings or profits unless all earnings and profits have first been distributed * * *." § 201 (e). "Any distribution made during the first sixty days of any taxable year shall be deemed to have been made from earnings or profits accumulated during the preceding taxable years; but any distribution made during the remainder of the taxable year shall be deemed to have been made from earnings or profits accumulated between the close of the preceding taxable year and the date of distribution, to the extent of such earnings or profits * * *." The first passage quoted is a recognition of a well settled legal principle, the second obviously an arbitrary rule of convenience. In accordance with this principle the average invested capital of a corporation is not reduced by the Treasury Department, on account of dividends paid, after the first sixty days of the year, out of current earnings. cf. *Appeal of L. S. Ayers & Co.*, 1 B. T. A. 1135.

** cf. Rev. Act 1918, § 214 (a) (3).

II. Income and Profits Taxes are Current Expenses When Due and Payable.

The validity of Article 845 of Regulations 45 was first questioned in *Appeal of Guarantee Construction Co.*, 2 B. T. A., 1145, where the Board of Tax Appeals said (p. 1150):

> "Income and profits taxes are a current annual expense as much as taxes imposed by any State or any political subdivision thereof, not including taxes assessed against local benefits. The fact that they are specifically excluded from the deductions allowed by the statute in determining the taxable net income does not in the least change their character. As annual expenses they constitute for accounting purposes proper charges against the earnings of the year in which they become due and payable, and the payment thereof can have no more effect upon the invested capital of the year in which the payment is made than would the payment of any other operating expense.
>
> "Nor is the rule different in the event that the current earnings available at the date of payment of the tax or any installment thereof are insufficient to meet the required payment. By express provision of the statute the earnings of the current year are in no wise reflected in the current year's invested capital. It follows that if the expenses at any given date exceed the income so as to show an operating deficit at that date, invested capital is not affected.
>
> "Section 326 (d) provides that: 'The invested capital for any period shall be the average invested capital for such period, * * *' and it might be urged that, in the event the tax for an earlier year paid in a later year exceeded the earnings of that year,

the resulting impairment of surplus should be reflected in invested capital for the year in which such tax became due and payable. We believe, however, that full effect may be given to the above-quoted section without requiring such a construction. Additions to capital resulting from the issuance of additional stock for a valuable consideration or reductions of capital or surplus resulting from distributions to stockholders in excess of earnings, thereby producing impairments of surplus, are necessarily to be taken into consideration as bearing upon invested capital since they affect the capital actually embarked or left in the enterprise. Since this provision of the statute may thus be given full effect without involving adjustments of income or expense of the year, we are of the opinion that there is nothing in the statute which requires that the invested capital of a taxable year be reduced on account of the payment of income and profits taxes for the preceding taxable year.

"We conclude that, so far as article 845 of Regulations 45 and 62, promulgated by the Commissioner, requires that such reduction in the invested capital be made, such regulations are without statutory warrant and are invalid. Any part of the deficiency on appeal which is predicated upon the reduction of this taxpayer's invested capital for 1919 on account of income and profits taxes for the year 1918, whether paid in the year 1919 or forming a part of the deficiency for the year 1918, is erroneous and is disallowed."

It is respectfully submitted that the reasoning of the Board was sound. In the case at bar the taxpayer's po-

sition is even stronger, for it appears (R. p. 26, ¶ V) that at the time of each payment on account of 1918 taxes in 1919, the taxpayer had on hand earnings of 1919 sufficient to meet it.

The Board's decision followed that in *Appeal of L. S. Ayers & Co.*, 1 B. T. A. 1135, where the Board held:

> "The invested capital of a corporation may not be reduced, in determining the extent to which a dividend is paid from current earnings of a year, by a 'tentative tax' theoretically set aside out of such earnings pro rata over such year, because the income and profits tax does not become due and payable, and, therefore, does not accrue, until the following year."

This decision, approved in *Com'r* v. *Pittsburgh Knife & Forge Co.*, 30 Fed. (2d) 522 (C. C. A. 3rd) and *Blair* v. *Ragley Lumber Co.*, 30 Fed. (2d) 683 (C. C. A. 5th), after some hesitation, has been accepted by the Treasury Department as the law, and is being regularly applied for all years in which the excess profits taxes were in force, notwithstanding certain decisions of the Court of Claims in apparent conflict.

III. The Opinion of This Court in United States v. Anderson is Not Applicable to Invested Capital for the Year 1919.

After the Board of Tax Appeals decided the *Guarantee Construction Company* case, this Court rendered its opinion in *United States* v. *Anderson* and *United States* v. *Yale & Towne Mfg. Co.*, 269 U. S. 422.* In that case this Court considered the question of whether a corpora-

* Cited under latter title in Memorandum below, R. p. 28.

tion which set aside on its books a reserve for Munitions Taxes for 1916, currently in 1916, should deduct those taxes from 1916 income, or from the income of 1917, in which year they were actually paid. It held that they should be deducted from 1916 *income*. The Court was not concerned with *invested capital*. It quoted Section 13 (d) of the Revenue Act of 1916, covering the computation of income, a provision *which has no counterpart in the sections of the 1918 Act covering invested capital.*

This Court said:

> "Only a word need be said with reference to the contention that the tax upon munitions manufactured and sold in 1916 did not accrue until 1917. In a technical legal sense it may be argued that a tax does not accrue until it has been assessed and becomes due; *but it is also true that in advance of the assessment of a tax all the events may occur which fix the amount of the tax and determine the liability of the taxpayer to pay it.*" (Italics supplied).

The Court, on the ground that *all such events had occurred* in 1916, held the tax deductible from 1916 income by a corporation which had set aside a reserve in 1916 to meet the tax. The Court said nothing with respect to the treatment of a tax which could not have been determined in 1916, but the inference is fair that the tax would not have been deductible for a year by the end of which all the events necessary to a determination of the liability *had not occurred*. The Court distinguished *United States* v. *Woodward*, 256 U. S. 632, on the ground that there

"It did not appear * * * as here, events had occurred before the tax became due which fixed the amount of it."*

The Court did not overrule the *Woodward* case, nor the cases of *Clapp* v. *Mason*, 94 U. S. 589, 592; *Mason* v. *Sargent*, 104 U. S. 689, 693; *Sturges* v. *United States*, 117 U. S. 363; *Wilmington Trust Co.* v. *United States*, 28 Fed. (2d) 205, 207, either directly or by implication.

In the case at bar all the events necessary for the determination of the petitioner's 1918 tax had not occurred by December 31, 1918. The first element in the determination of a tax is the statute under which it is assessable. *And the so-called Revenue Act of 1918 was not enacted until February 24, 1919.*

IV. A Tax Cannot be Determined Before the Passage of the Statute Enacting it.

The case of *Schuster & Co., Inc.*, v. *Williams*, 283 Fed. 115, is exactly in point. In that case the taxpayer, a corporation making its returns on the accrual basis, sought to deduct from its gross income in computing its 1918 Federal income tax, a surtax on its income for that year imposed by the State of Wisconsin under a Soldiers' Bonus Act passed in 1919.

The Circuit Court of Appeals, affirming the decision of the District Court, and *sustaining the Government's contention*, said (p. 116):

"Since the act creating the tax was not passed until after the federal income tax year of 1918, this

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* cf. Government's brief in *United States* v. *Anderson*, pp. 38-40, distinguishing the *Woodward* case on the ground that *"various events subsequent to the date of the decedent's death * * * were necessary factors in computing the amount of the tax."* And *"an attempted accrual would have been a mere speculation."*

soldiers' bonus tax can *in no sense* be deemed to have accrued during the calendar year prior to that of its passage." Citing *United States* v. *Woodward* et al., 256 U. S. 632. (Italics supplied).

If the Wisconsin bonus tax was not deductible in 1918 because, being imposed by a law enacted in 1919, it did not *accrue* as a liability in 1918, it follows that the Federal income and profits taxes for 1918, imposed by a law enacted in 1919, could not have accrued as a liability during or at the end of the year 1918.

After the decision of *United States* v. *Anderson*, the General Counsel of the Bureau of Internal Revenue ruled that the *Anderson* case did not apply to the time of accrual of property taxes, which could not accrue until the tax roll had been completed, the value assessed and the rate determined (G. C. M. 1240, C. B. VI-1 p. 65). In Appeal of *Petaluma & Santa Rosa R. R. Co.* v. *Commissioner*, 11 B. T. A. 541, the Board of Tax Appeals held that the *Anderson* case did not apply to the time of accrual of the California franchise tax where the tax was measured by the receipts of the preceding year, since there was no liability for the tax for that year and never would have been had the corporation ceased to operate at the end of the preceding year.

In *Appeal of L. S. Ayers & Co.*,* referred to above, the Board of Tax Appeals aptly said:

"If the tax imposed by Congress under the Revenue Act of 1917 did not constitute such an impairment of surplus as to invalidate a declaration of dividend made prior to the passage of the Act, how

* The Court is respectfully referred to this opinion (1 B. T. A. 1135) for an exhaustive review of the authorities on accrual of taxes.

> can it be said that earnings during the year 1918 were *pro tanto* set aside or subject to be set aside for the payment of a tax not then existing and not brought into existence until February, 1919?

and:

> "It is not to be assumed that Congress intended the computation of invested capital to be unnecessarily complex by a strained interpretation which reduces the earnings of the year otherwise available for distribution on account of a tax thereafter to be imposed."

Similar rulings by the Treasury Department are found in O. D. 1118, 5 C. B. p. 133; I. T. 1498, C. B. I-2 p. 95; I. T. 2118, C. B. III-2 pp. 251, 253; I. T. 2281, C. B. V-1 p. 58; I. T. 2304, C. B. V-1 p. 74.

It is respectfully submitted that *United States* v. *Anderson* is not authority for the proposition that a tax can accrue as a liability before the passage of the statute enacting it.

V. The Congressional Intent in the 1918 Act.

Some light as to the legislative purpose of Congress is given by the report of the Senate Finance Committee on the 1918 Revenue Act. Prior to the enactment of the Revenue Act of 1917 Federal income taxes were deductible in the ascertainment of net income. A change was made by that act whereby all taxes were allowed as deductions *except* income and excess profits taxes imposed by authority of the United States, and, of course, taxes assessed against local benefits. The Senate Finance Committee, in its report approving the bill, stated:

> "Second. That in arriving at the net income no deduction shall be allowed for income and war-prof-

its taxes paid during the year. The amount of these taxes payable during the fiscal year 1918, principally between June 15 and 25, it is estimated will be about $1,400,000,000. If in computing the net taxable income of the year 1918 this amount be deducted the revenues of the Government would be reduced for the fiscal year 1919 to such an extent as to require a considerable increase in the rate of the income tax and possibly in the war-profits tax."

The Committee was speaking of the taxes imposed by the 1917 law, becoming due and payable during 1918, and contemplated (except for the amendment) the deduction of such taxes from 1918 receipts in the ascertainment of the net income on which the 1918 taxes collectible in 1919 would be based. Clearly, we submit, Congress had no thought of the deduction of the 1917 taxes from the 1917 gross income in the ascertainment of the 1917 tax. It follows then that the earned surplus for 1917 could not be reduced by the 1917 taxes, since the taxes were deemed by Congress to be chargeable against the 1918 income, except for the denial of the deduction. Similarly Congress never expected 1918 earned surplus to be reduced by 1918 taxes, which it expected would be paid out of 1919 income.

VI. Section 1207 of the Revenue Act of 1926 is Not Applicable to the Facts of This Case.

Had this case been decided in 1925, there would, of course, have been no occasion to construe any statute other than the Revenue Act of 1918. But the Government contends that recovery in this suit is foreclosed by Section 1207 of the Revenue Act of 1926. The petitioner's position with respect to such a contention is that Section 1207 was not intended to have the effect given

it by the Treasury Department, but, if so construed, it would be of highly doubtful constitutionality, as an invasion by the legislature of the province of the judiciary.

The *Guarantee Construction Company* case was decided on October 30, 1925. The *Anderson* case was decided by this Court on January 4, 1926. The latter decision involved an entirely different question with respect to a tax of a fundamentally different nature imposed by a different revenue act.

A hasty construction of the *Anderson* case by the Treasury Department led to the conclusion that article 845 of Regulations 45 was wrong, not in the respect decided by the Board in the *Guarantee Construction Company* case, but because it permitted income and profits taxes of one year to remain in invested capital for any portion of the succeeding year. This conclusion meant that the Treasury Department, unless relieved by Congress, would feel obliged to reopen all closed cases against which the statute of limitations had not already run and assess additional taxes based on invested capital reduced by the entire rather than the partial deduction of prior years taxes. Not only that, but it meant also that the Department would not be able to close, without extended litigation, thousands of cases which could otherwise be settled. The Department was, therefore, faced with a very serious administrative problem.

In order to solve this administrative difficulty, the then pending revenue bill was amended by adding a paragraph which became Section 1207 of the 1926 Act. This section was intended solely to give the Treasury Department the necessary legislative authority to forego undertaking this huge administrative task which would otherwise have been necessary under the Department's interpretation of the effect of the *Anderson* decision. Clearly

there was no intention by Section 1207 retroactively to amend prior revenue acts to increase taxes for past years, nor, without retroactive amendment, to attempt legislatively to place an interpretation on the prior acts which would be binding on the courts. The purpose of the section was to relieve the Treasury Department from the difficulties and taxpayers from the burdens which would occur under the Treasury's theory of the *Anderson* case.

The Board of Tax Appeals, in *All America Cables, Inc.*, 10 B. T. A. 213, 218 ff. made a careful abstract of the regulations and decisions leading up to the enactment of Section 1207 of the Revenue Act of 1926, and said, in passing:

> "At this time [1926] many returns for the years affected by these regulations had been audited and the statute of limitations had run against the collection of the taxes on many of these returns in which the taxpayer had received the benefit of these regulations. The Treasury Department, therefore, was faced with the proposition of reversing its existing practice with respect to returns which were not yet closed, which would have meant an inequitable situation for these taxpayers as compared with more fortunate taxpayers who had the benefit of existing regulations. Congress apparently recognized this condition in enacting section 1207, which removed the question from the field of controversy and validated existing regulations with respect thereto."

The question removed from doubt was whether it was incumbent upon the Treasury to demand *still more* taxes from all corporations for the years 1917-1921 inclusive. The question in this case, i. e. whether the Commissioner had already asserted too much tax for *1918*, was not involved.

VII. The Treasury Department's Construction of Section 1207 of the 1926 Act Raises Serious Doubts as to its Constitutionality. Such a Construction is Avoidable.

It is well settled that where a statute is susceptible of two constructions, by one of which grave constitutional doubts arise, and by the other of which such doubts are avoided, it is the duty of a court to adopt the latter.

United States v. *Delaware & Hudson Co.*, 213 U. S. 366, 407-408. *Texas* v. *Eastern Texas R. Co.*, 258 U. S. 204, 208.

As recently as January 2, 1929, this Court, in *Russell* v. *United States*, 278 U. S. 181, speaking with reference to the Revenue Act of 1924 said:

> "The changes introduced into the Act of 1926 cannot authorize construction of the earlier one not consonant with the language there employed."

As the legislature cannot set aside the construction of a law already applied by the courts, neither can it compel the courts for the future to adopt a particular construction of a law which the legislature permits to remain in force, unchanged. To declare what the law is, or has been, is a judicial power; to declare what the law shall be, is legislative. One of the fundamental principles of our government is, that the legislative power shall be separate from the judicial. If the legislature would prescribe a different rule for the future from that which the courts have enforced, it must be done by direct enactment, and cannot be done by a mandate to the courts, which leaves the law unchanged, but seeks to construe and apply it, not according to the judicial, but according to the legislative judgment. Cooley's Constitutional Limitations, 6th Ed., Chap. V, p. 113.

In *United States* v. *Salberg*, 287 Fed. 208, the court said:

> "A Legislature may enact a law, and, if not forbidden by the Constitution, may make it apply ex-post facto or retroactively; but the Legislature may declare what the law shall be, but not what it was."

The leading case on this point is probably *Town of Koshkonong* v. *Burton*, 104 U. S. 668 (1882). The plaintiff brought action against the defendant municipal corporation on a bond issued by the latter. The state statute in force at the time of the execution of the bond provided for a maximum rate of interest, and this act was construed by the state Supreme Court to permit compounding of interest. Subsequently the legislature passed an act declaring that "it was and is the true intent and meaning of" the prior statute that interest should *not* be compounded. This Court held this declaratory act was without effect so far as it concerned rights already accrued under the prior act, saying:

> "By the 1st section of the Act of 1868 the Legislature assumed to declare what was the true intent and meaning of previous legislation prescribing and limiting the rate of interest. * * *
>
> "Prior to the passage of the Act of 1868 the highest judicial tribunal of the State had adjudged that when a sum was to be paid at a specified time, as interest, that sum bore interest from that time until paid. This was an adjudication as to what was the local law in that class of cases. And the utmost effect to be given to a subsequent legislative declaration, as to what was the proper meaning of the statutes which had thus been the subject of judicial construction would be to regard it as an alteration of

the existing law in its application to future transactions, especially where, as was the case in the Act of 1868, that declaration was accompanied by a distinct provision, in terms, changing the pre-existing law.
* * *

"It is clear, therefore, that neither the Act of 1868, nor the provision quoted from the revision of 1878, which is but a continuation of the 2nd section of the Act of 1868, can be deemed applicable to the case before us. The contract between the Town and the holders of its securities was entered into prior to those enactments, and the rights of the parties must, necessarily, be determined by the law as it was when the contract was made. It was not within the constitutional power of the Legislature to take from the plaintiff his right, whether arising on express or implied contract, to interest upon interest, if when the coupons were executed and delivered, he, or the then holder thereof, had such right, under the law of the State."

It is clear that the 69th Congress could not constitutionally give to the words, "Paid-in or earned surplus, and undivided profits," in Section 326 of the 1918 Act, a meaning contrary to or different from that intended by the Congress that enacted that Act. Hence this Court will, if possible, give to Section 1207 an interpretation which does not imperil its constitutionality.

Congress undoubtedly recognized the constitutional limitation against performance of judicial functions by the legislative branch. That is evident from the language used in Section 1207.

Section 1207 is susceptible of a construction which will not imperil its constitutionality and which will not pre-

clude this Court from deciding this case upon the basis of the language of the Revenue Act of 1918.

Section 1207 reads as follows:

> "The computation of invested capital for any taxable year under the Revenue Act of 1917, the Revenue Act of 1918, and the Revenue Act of 1921, shall be considered as having been correctly made, *so far as relating to the inclusion in invested capital for such year of income, war-profits, or excess-profits taxes for the preceding year*, if made in accordance with the regulations in force in respect of such taxable year applicable to the relationship between invested capital of one year and taxes for the preceding year."

To analyze this section, it should be noted that the 69th Congress did not say, "The computation of invested capital * * * *was* correctly made * * * if made in accordance with the regulations * * *." Such language would clearly have evidenced the desire of Congress to deprive the courts of their judicial power to construe past legislative enactments. What it did say was, "The computation * * * *shall be considered as having been* correctly made * * *."

The choice of this phraseology shows that the sole purpose of the provision was to relieve the Treasury of reopening thousands of closed cases and holding open thousands of others while the question of the possible application of the rule of the munitions tax cases was being litigated in the courts.

It should be noted also that Congress put its stamp of approval on the Treasury regulations only so far as they related to the *inclusion* in invested capital of a particular year of income, war-profits, or excess-profits taxes

for the preceding year. The Commissioner had *included* only a part of such taxes. But Congress refrained from expressing its view on the propriety of the Commissioner's action in *excluding* a part of such taxes, leaving such question for determination in a proper case such as the instant one. This construction is supported by the presence in the section of the following clause:

> "so far as relating to the inclusion in invested capital for such year of income, war-profits, or excess-profits taxes for the preceding year,"—

for, if Congress intended retrospectively to adopt the regulations unqualifiedly and in their entirety, it would have referred to the general treatment of such taxes—not merely their *inclusion*, when it was well known that they had been partly included and partly excluded.

Accordingly, it is submitted that in deciding this case the Court may regard Section 1207 of the Revenue Act of 1926 as inapplicable.

VIII. The Authorities Cited Below Distinguished.

The Court of Claims dismissed the plaintiff's petition without opinion, merely citing three court cases, none of which dealt with a case involving the reduction of invested capital as at January 1, 1919, by taxes for 1918 computed under a statute enacted *after* January 1, 1919, and *none of which considered the impossibility of accruing a tax as of a date before the enactment of the statute imposing the tax*; and one Board decision in which no opinion was rendered on the issue herein involved.

The case of *United States* v. *Yale & Towne Mfg. Co.*, 269 U. S. 422, has been discussed under its more familiar title of *United States* v. *Anderson*.

In *Nichols* v. *Sylvester*, 16 Fed. (2d) 98, the statute involved was that of October 3, 1917, and the questions

were as to the *inclusion* of 1917 taxes in invested capital for 1918, whether Section 1207 of the Revenue Act of 1926 referred to regulations in force in 1918 or subsequent to the taxable year, and, accordingly, whether the Commissioner could collect taxes *in excess* of those contemplated by the regulations. The question at bar was not raised by either party or considered by the court. As this Court said in *United States* v. *Mitchell,* 271 U. S. 9, 14:

> "It is not to be thought that a question not raised by counsel or discussed in the opinion of the court has been decided merely because it existed in the record and might have been raised and considered."

In *Bowers* v. *Kaufmann,* 18 Fed. (2d) 69, the question arose with respect to reducing 1918 invested capital by taxes assessable under the 1917 Act—enacted *before* the date as at which the reduction was made.

In *Russel Wheel & Foundry Co.,* 3 B. T. A. 1168, the Board gave no reasoning but contented itself with quoting Section 1207 of the Revenue Act of 1926 and Article 845 of Regulations 45, and holding that the latter was in force when the former was enacted.

The failure of the Court of Claims to answer the contention of the petitioner suggests that it accepted the statement in the Government's brief, "Its [plaintiff's] income and profits taxes for 1918 had wholly accrued on December 31, 1918," citing the three court cases distinguished above. The Court of Claims made no effort to show how a tax could wholly accrue in the absence of a prime factor in its computation—the enactment of the statute under which it was both computed and assessed.

Its decision is in disregard of the opinion of this Court in *United States* v. *Woodward* and the cases cited above on p. 14.

It is respectfully submitted that the numerous taxpayers whose taxes for the calendar year 1918 are still in dispute are entitled to something better than this summary treatment, and to a hearing upon the question involved—that they may learn from this Court, in an opinion, the manner in which they might have been expected to accrue on December 31, 1918, an accurate estimated computation of taxes under a statute which was not yet on the books.*

CONCLUSION

The Writ of Certiorari prayed for in the petition should be granted.

Respectfully submitted,

J. S. Y. IVINS,
Attorney for Petitioner.
c/o HOLMES, BREWSTER & IVINS,
815 Fifteenth Street, N. W.,
Washington, D. C.

*It is interesting to compare the position of the Government in this with that which it took in *Lucas* v. *American Code Co.* decided by this court in its favor on February 24, 1930.